14.03 Preferred Stock & APIC

Preferred Stock

Preferred Stock refers to stock similar to a debt instrument with two advantages over common stock:

- **Dividends** – preferred shares must be paid a dividend before the company is allowed to pay the common shareholders a dividend.
- **Liquidation** – if the corporation liquidates, preferred shareholders must be paid before the common shareholders.

The **dividend preference** for preferred shares is based on a stated dividend rate that is computed on the par (or stated) value of the shares. Keep in mind that dividends are optional, however, and a company may decide not to pay any dividends at all in a particular year to any shareholders. The preferred shareholders have a dividend preference, not a dividend guarantee.

To see how the allocation of dividends is computed, assume a client has two types of stock outstanding at 12/31/X6, at which time $300 of dividends are declared:

Type of shares	Par value	Shares	Total
10% Preferred stock	$100	4	$400
Common stock	$1	100	$100

Of the $300 in dividends, the first $400 × 10% = $40 must be paid to the preferred shareholders, based on the dividend preference. The remaining $260 is paid to the common shareholders.

Along with the stated annual preference, preferred shareholders may be paid additional amounts if the shares are:

- **Cumulative** – dividends missed in earlier years must also be paid before the common shareholders receive anything.
- **Participating** – if the common shareholders get a dividend that is a higher rate on its par value than the stated rate on the preferred shares, the preferred shareholders must get the same higher rate.
- **Convertible** – the preferred shareholder has the option of converting their stock for common stock at a specified ratio.
- **Callable** – the corporation has the option of repurchasing the preferred stock at a specified price.
- **Preferred with Warrants** – the warrants are convertible into shares of common stock.

Assume, for example, that the company in the preceding example paid the same $300 in 20X6, but paid no dividends in the 5 years 20X1 to 20X5. Notwithstanding their preference, the preferred shareholders received nothing in those years. If the stock is not cumulative, the preferred shareholders will still only receive $400 × 10% = $40. If, however, the stock is cumulative, then the $40 preferences missed for 5 years result in $200 of dividends in arrears at 12/31/X5. In 20X6, when $300 is paid, the preferred shareholders will collect $240 and the common shareholders $60, determined as follows:

Amount	Shareholders	Reason
$200	Preferred	Dividends in arrears
$40	Preferred	Annual preference
$60	Common	Remainder

If the preferred shares are not cumulative, but are participating, they will still receive more than their annual preference when $300 is paid in 20X6. First, they receive $400 × 10% = $40 as their annual preference. Next, the common shareholders are paid, but only until they are also receiving 10% on their par value, or $100 × 10% = $10. The remaining $250 is allocated to the preferred and common shares based on their relative par values:

Type of shares	Total par value	Percentage of combined
Preferred	$400	80%
Common	$100	20%
Total	$500	100%

Thus, the preferred shares get an additional $250 × 80% = $200 and the common shares an additional $250 × 20% = $50. The preferred shareholders end up receiving $40 + $200 = $240 and the common shareholders $10 + $50 = $60. In each case, the shareholders are getting dividends equal to 60% of par value, so the preferred shares are fully participating in the large dividend.

When a company liquidates, preferred shareholders are paid first, based on the amount of their **liquidation preference**. Unless specifically stated, this is usually the same as the par value of the preferred shares. Remember, however, that a liquidating distribution is still a form of dividend, so preferred shareholders must also be paid dividends in arrears on top of their liquidation preference. The remainder is paid to common shareholders. The amount that each outstanding common share is entitled to receive is known as **book value per common share**. The calculation of BV per C/S share is Common Shareholders equity / Common shares outstanding.

To demonstrate the calculation of liquidation payments and book value, assume the stockholders' equity section of the client is as follows on 12/31/X1, and that no dividends have been paid in 20X1:

Account	Amount
8% Cumulative Preferred stock - 5 shares authorized and issued @ $100 par, $110 liquidation value	$500
C/S – 5,000 shares authorized, 103 shares issued @ $1 par	103
APIC	200
Retained earnings	223
Treasury stock, at cost – 3 shares @ $12	(36)
Stockholders' equity	$990

The preferred shareholders are entitled to receive the liquidation preference of $110 × 5 shares = $550 and the dividends in arrears of $500 × 8% = $40, for a total of $590. The common shareholders receive the remaining equity of $990 - $590 = $400. The book value per share of preferred stock is $590 / 5 = $118, and the book value per share of common stock is $400 / 100 = $4. Notice that the book value is based on the shares outstanding.

Additional Paid-In-Capital (APIC)

There are many forms of additional paid-in capital (APIC) (contributed capital) that may be included in the stockholders' equity section of the balance sheet, including:

- **Common stock** – The portion of the issue price of common stock that exceeded the par (or stated) value of the shares.
- **Preferred stock** – The portion of the issue price of preferred stock that exceeded the par (or stated) value of the shares.
- **Retired stock** – Repurchase and retirement of shares below the original issue price.
- **Treasury stock** – Repurchase of shares below the original issue price under the par value method and resale of shares above the repurchase price under the cost method.
- **Warrants** – The amount allocated to the value of detachable warrants that are issued with bonds or preferred stock.

Companies may issue securities that give the holders the right to buy shares of stock at an established price for a specific period of time. Examples of these securities are **stock rights** which are often issued to existing shareholders, **stock options** which are often issued to officers or employees, and **stock warrants** which are often issued to bondholders.

Stock rights (sometimes called *preemptive or subscription rights*) are contractual rights held by existing shareholders to purchase a proportional share of new shares in the same class, to preserve their preexisting ownership percentage (prevent dilution of ownership).

There are, however, many other types of transactions that may affect APIC.